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ECONOMIC MANAGEMENT AND CLIMATE CHANGE: THE OPPORTUNITY FOR THE UK

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The policy response to the economic impacts of the current pandemic will shape the global economy through the 'crucial decade' for keeping the rise in global temperature from climate change to well below 2°C. Addressing both crises successfully will require synchronised reforms to macroeconomic management, financial policy and financial institutions.

The UK has a unique opportunity to make financial reforms which address the economic challenges of COVID-19 and climate change, both at national level and through its international leadership roles in 2021. **Reframing economic analysis and planning to drive the required systemic change both globally and domestically involves formulating responses to these questions:**

> **What is the long-term strategy?** What needs to be financed and how much investment is required to deliver this strategy?

> **Who will finance it?** What are the roles of private and public finance, and of national and international actors?

> **How will finance be delivered?** What systemic changes are needed to ensure that finance is delivered where it is needed, and at the scale and pace required?

Although these may seem obvious questions, answering them requires a fresh approach to economic planning. Long-term goals need to be identified and synergies between different elements of the economy understood.

Based on these questions, this paper sets out two key recommendations relating to a range of domestic and international policy opportunities, and proposes associated actions which will help drive the UK's economic recovery from the COVID-19 crisis, set a precedent for other countries to follow as an action for COP26, and mitigate the economic risks of climate change.

Our two key recommendations are:

1. **The creation of a UK plan for financing climate resilience and net-zero emissions by 2050 as part of wider economic recovery plans**;
2. **Inclusion of macroeconomic management within the UK's COP26 Presidency finance priorities.**

The creation of a UK plan for financing net-zero and resilience as part of a strategy for economic recovery

The UK has a strong history of leading on green and sustainable finance in both the domestic and international spheres. The 2019 Green Finance Strategy included important innovations aimed at greening public finance, such as the inclusion of climate change in the government's analysis of fiscal risks. However, announced very shortly after the UK's decision to set a legally binding target for net-zero emissions by 2050, it was not possible for the Green Finance Strategy to represent a fully thought-through plan of action for financing the UK's climate mitigation and adaptation needs.

The UK now has an opportunity to create a new financing plan that underpins the UK's wider economic recovery and the transition to a resilient zero-carbon economy. To build on the Green Finance Strategy, and in order to identify the areas where deploying public finance will have the greatest leverage, the UK should quantify both the level of investment that will be required for a resilient climate transition and the likelihood that the private sector will meet these needs on its own without additional actions by government. HM Treasury's upcoming review into funding the transition to a net zero greenhouse gas economy[1] provides an ideal opportunity to conduct this quantification, which will provide the basis for planning the scale and type of policy approach required. This should be prioritised as it will ensure that important investment decisions underpinning the economic recovery are also based on an improved understanding of the costs and benefits of the transition to net zero emissions. In the interim prior to the completion of such an assessment, and recognising the need for stimulus measures that can be fast tracked, focus should be placed on no-regrets net-zero energy infrastructure and energy efficiency projects which meet important criteria and can drive an economic recovery that also puts the country on track to meet its target for net-zero emissions.

Any new plan should be informed, but not restricted, by the UK's National Adaptation Programme. It should include measures that will enable increased finance for resilience in line with the UK's identified adaptation needs.

[1] https://www.gov.uk/government/publications/net-zero-review-terms-of-reference/hm-treasurys-review-into-funding-the-transition-to-a-net-zero-greenhouse-gas-economy-terms-of-reference

Without such a comprehensive assessment of the scale and type of funding needed, climate mitigation and adaption policies risk falling short of what is needed and may build in future risk to the UK economy. A lack of quantification of either the fiscal risks of climate change or the costs of measures to offset them will undercut the effectiveness of the government's long-term response to the economic crisis induced by COVID-19. The management of the fiscal implications of climate risk is a statutory obligation following the publication of the 2019 Office for Budget Responsibility Fiscal Risks Report– to which HM Treasury must respond[2].

We recommend that HM Treasury takes forward several measures as part of sound macro-economic management:

> **HM Treasury's review into funding the transition to a net zero greenhouse gas economy should include a quantitative assessment of the UK's climate investment needs.** Quantification should be done under different scenarios taking, for example, the Bank of England's scenarios[3] as a reference. The Climate Change Committee estimates a total resource cost to transition of between 1-2% of GDP by 2050[4]. A definitive UK assessment of investment needs will lead to an improved understanding of the costs and benefits of the transition, the extent that the private sector can deliver the investment required, and how best public capital can be deployed to create additionality.

> **The review into funding the transition to a net zero greenhouse gas economy should inform the development of a UK strategy to ensure that the distribution of costs and benefits associated with the transition is fair.** The current crisis has exacerbated existing inequalities and created new risks to employment in many sectors and regions and, as noted by the Climate Change Committee[5], places an even greater priority on the fair distribution of policy costs and benefits.

> **HM Treasury should establish a National Infrastructure Bank as a dedicated financial institution with a clear mandate to support the net-zero and resilient transition.** This type of institution has the potential to crowd-in private investment, for example in renewable energy and energy efficiency, while developing climate-resilient infrastructure and could further contribute to rebalancing regional economic development and supporting SMEs[6]. A new UK green bank would help fill the gap left

[2] HM Treasury are legally committed to respond to the OBR Fiscal risks report as outlined in the **Charter for Budget Responsibility**.

[3] Bank of England (2019). **The 2021 biennial exploratory scenario on the financial risks from climate change.**

[4] Climate Change Committee (2019).

[5] CCC letter to the Prime Minister and First Ministers in Scotland, Wales and Northern Ireland: Building a resilient recovery from the COVID-19 crisis. Available: **https://www.theccc.org.uk/publications/**

[6] Allan, J., Donovan, C., Ekins, P., Gambhir, A., Hepburn, C., Robins, N., Reay, D., Shuckburgh E., and Zenghelis, D. (2020). A net-zero emissions economic recovery from COVID-19. Smith School Working Paper 20-01.

by the UK's departure from the European Investment Bank[7]. The concept was previously demonstrated as viable for the UK by the Green Investment Bank which, whilst under public ownership, mobilised £12 billion of private investment with £3.4 billion of public capital[8,9]. Public debt would not increase as a result of this action due to the 2008 adjustment of government accounting rules to exclude the liabilities of publicly owned banks from net UK debt[10].

> **The UK's Whole of Government Accounts (WGA) should be restructured in order to identify and designate green spending across sectors; this would allow the HMT to assess whether public finance is being deployed as required to deliver the UK's goals[11].** The WGA could be adjusted to count adaptation as an investment instead of spending, as adaptation is known to provide indirect returns[12]. As part of an overall alignment of the WGA with the Paris Agreement, the UK public sector's exposure to climate-related financial risks could be evaluated and disclosed in line with the recommendations of the Taskforce for Climate-related Financial Disclosure. The UK could also publicly set out an approach to dealing with contingent liabilities associated with climate risk within the UK's public accounts.

> **The UK should take practical steps to monitor and evaluate the effectiveness of public finance in the context of climate change:**

- The UK could periodically **develop a Green Balance Sheet** to assess its environmental assets and liabilities building on the existing tools[13]; this could be part of the Balance Sheet Review process[14].
- A **green performance report** could assess the UK's green budget and balance sheet in relation to the UK's stated targets; this could be included in the Annual Report and Resources Account.
- **Stress testing the UK's fiscal outlook to 2050** as part of the Managing Fiscal Risks report could support efforts to make the economy resilient to shocks.

[7] Aldersgate Group (2018). **Towards the new normal. Increasing Investment in the UK's Green Infrastructure.**

[8] See https://www.e3g.org/library/global-britain-needs-the-green-investment-bank

[9] See https://blogs.lse.ac.uk/politicsandpolicy/kwasi-kwarteng-does-the-uk-need-its-own-infrastructure-bank/

[10] Mazzucato, M, and Macfarlane, L (2017). **Patient strategic finance: opportunities for state investment banks in the UK**

[11] **OECD has done work on this matter.**

[12] **https://www.macquarie.com/au/en/perspectives/the-adaptation-imperative.html**; https://www.spglobal.com/_assets/documents/corporate/ratingsdirect_pluggingtheclimateadaptationgapwithhighresiliencebenefitin.._.pdf

[13] https://blog-pfm.imf.org/pfmblog/2019/07/high-time-for-green-budgeting.html

[14] https://blog-pfm.imf.org/pfmblog/2019/06/reviewing-the-uk-balance-sheet-proving-its-net-worth.html

> **The UK could create a National Resilience Office within the Cabinet office** with responsibility for considering the resilience implications of all investment plans and decisions and ensuring that appropriate steps are taken to address them[15]. The Office should work closely with the Infrastructure and Projects Authority.

> **In the medium term, the UK should consider reviewing its fiscal rules to increase limits for climate related borrowing and/or should reconsider its actual fiscal space.** This could result in more fiscal space to finance climate investments so that debt levels would not be a constraint on green investments, based on the likelihood that the return on green investment would be greater than any increased costs.[16,17]

> **All UK public finance, including UK Export Finance and ODA, should cease financing fossil fuel projects abroad and replace with clean energy funding.** The failure of UK government to align all its financial flows with the Paris climate commitments undermines the credibility and influence of UK's international climate leadership.

> **The Office for Budget Responsibility should support HM Treasury to commit to testing its GDP growth forecasts against different plausible future climate change scenarios**. The UK as a whole should follow the Environment Agency in making use of a 4-degree scenario, which has already been proposed by the Climate Change Committee as the appropriate scenario to use when planning UK climate adaptation.[18]

In addition, HM Treasury should take forward the following actions in relation to its role as a regulator of private finance:

> **Require companies and financial firms to disclose climate risk by 2022 in line with the recommendations of the Taskforce on Climate-related Financial Disclosure (TCFD).** Mandatory TCFD adoption is a litmus test for UK leadership on green finance and is already central to the finance strategy of the UK's COP26 Presidency. In its statement on prioritisation in light of Covid-19 the Prudential Regulation Authority (PRA) outlined its commitment to the continued focus on embedding climate disclosure across the financial system[19] and the UK through the PRA's work is well placed to lead on ensuring financial resilience to climate risk.

[15] **Fifteen Steps to Green Finance**.

[16] https://www.common-wealth.co.uk/reports/public-finance-for-a-green-new-deal-why-we-need-to-change-the-rules#chapter-3

[17] https://blogs.imf.org/2018/06/27/economic-preparedness-the-need-for-fiscal-space/

[18] https://www.theccc.org.uk/wp-content/uploads/2019/07/CCC-2019-Progress-in-preparing-for-climate-change.pdf

[19] **https://www.bankofengland.co.uk/prudential-regulation/publication/2020/pra-statement-on-prioritisation-covid19**

> **Require UK-regulated financial firms to publish their plans for Paris alignment by 2021.** As outlined by Mark Carney[20] in his role as Prime Minister's Finance Adviser for COP26, financial and real economy firms will increasingly be expected to develop and disclose their transition plans as recommended by the TCFD. The UK can take a leadership role by making this a requirement for the financial sector.

Inclusion of macroeconomic management within the UK's COP26 Presidency finance priorities

The UK will have a generational opportunity in 2021 to drive systemic financial reform internationally through its Presidencies of COP26 and the G7. Although the macroeconomic reforms that are required to deliver a climate-safe world may appear complex, the current pandemic has become a potent accelerant of change and the speed and scale of necessary public intervention in response to COVID-19 is comparable to that required by climate change.

The health crisis has exacerbated existing inequalities, as well as fiscal limitations in developing economies. This will be compounded by a significant increase in global debt, with the consequences of this particularly acute in developing economies. Debt relief will be crucial in the short term to ensure that lower income countries have the resources required for vital healthcare and other relief efforts. To have an exit route from this crisis, both developing and emerging economies would need to access net new financing that can support them to shift to a more resilient and sustainable economy. The debt issue compounds the health crisis and makes systemic reform vital to avoid a longer-term humanitarian crisis. UK leadership of the international community is critical to this.

If governments around the world fail to apply the pandemic-driven momentum for financial system change to long-term climate policy goals this will make it far more challenging to deliver a resilient, climate-safe global economy in the future. In the previous section we have argued for the creation of a UK plan for financing national climate mitigation and adaptation actions. Other countries will also benefit from the development of national investment plans and capital mobilisation strategies for ambitious long-term real economy objectives such as net-zero emissions and climate resilience.

Even prior to COVID-19, macroeconomic interventions were warranted in the financial system. Despite historically low interest rates, economic growth was

[20] https://www.bankofengland.co.uk/-/media/boe/files/speech/2020/the-road-to-glasgow-speech-by-mark-carney.pdf?la=en&hash=DCA8689207770DCBBB179CBADBE3296F7982FDF5

sluggish around the world and infrastructure investments were insufficient[21]. Moreover, despite strong incentives, private capital was not delivering the infrastructure required for the Paris Agreement – particularly in developing countries. Whilst some of this infrastructure investment gap was being filled by Chinese public financing institutions, this brought its own issues, such as carbon intensive infrastructure and debt sustainability issues[22].

The UK now has a time-limited platform to push for new norms in macroeconomic management globally in support of the Paris Agreement and the COVID-19 recovery. As well as working with Multilateral Development Banks (MDBs) and the International Monetary Fund (IMF) as powerful allies, the UK's role as a member of the Coalition of Finance Ministers for Climate Action gives it leverage to promote reforms to macroeconomic policy, including fiscal planning, budgeting, public investment management, and procurement practice[23].

Strategic actions for macroeconomic oversight that the UK COP26 Presidency should promote internationally include the following:

> The UK should **promote the development of national investment plans and capital mobilisation strategies for mitigation and adaptation actions that support NDCs and are aligned with Long Term Strategies[24].** Financial plans based on long-term thinking can support a significant enhancement in the quality of the global stock of NDCs in this revision cycle, particularly if better tied to national planning and other macroeconomic policies.

> **The UK as G7 and COP26 President could convene different coalitions addressing economic management under a common framework for action**, including the EU's International Sustainable Finance Platform, the Network of Greening the Financial System and the Coalition of Finance Ministers, creating a connective tissue for economic management reform to be cascaded to national level.

> **The UK should take a leadership role within the Coalition of Finance Ministers for Climate Action** and work with the partners in the coalition to push forward a global green recovery. Currently, this coalition is drafting a guidance note on the COVID-19 response which presents a key window for promoting incorporation of climate risks and opportunities into recovery packages. In this role the UK should build a group of like-

[21] https://blogs.lse.ac.uk/businessreview/2016/10/14/negative-interest-rates-are-an-opportunity-for-the-uk-to-invest-in-sustainable-infrastructure/; https://outlook.gihub.org/

[22] https://www.brookings.edu/research/understanding-chinas-belt-and-road-infrastructure-projects-in-africa/

[23] https://www.cape4financeministry.org/sites/cape/files/inline-files/Santiago%20Action%20Plan%20-COP25%20-%20final.pdf

[24] http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=EZSHARE-1151369642-91; https://www.climatechangenews.com/2020/01/15/long-term-decarbonisation-strategies-boon-latin-america/

minded countries (e.g. Finland, France, Netherlands, Chile, and others) that will commit to incorporate climate change implications into macroeconomic policy, including fiscal planning, budgeting, public investment management, and procurement practice.

> **As a shareholder of the IMF, the UK should influence its Board to support the IMF Director's proposals for a green recovery**[25], as well as mandating the IMF to provide technical support for the long-term decarbonization plans. This could also incorporate reassessments of countries' fiscal space, as well as a further allocation of Special Drawing Rights to support green investments – both established proposals which require support to be taken forward.

> **In the recovery phase, Development Policy Loans (DPLs) by the World Bank are likely to become an important strategic instrument for financing climate goals** as an increasing number of countries request financial support. DPLs can engage national ministries of finance in the identification of financing plans for climate mitigation and resilience, as part of a wider economic recovery strategy. By putting nationally originated NDCs at the heart of the finance discussion DPLs offer a potential route to mutually acceptable climate conditionality, while also fostering increased future ambition and technical capacity. To help address the issue of NDCs which fall short of full Paris ambition, DPLs should focus on the no-regrets programmatic aspects of national commitments and could also include a clause calling for improving NDCs e.g. enhancements to costing, assessment of investment risk and opportunity, and integration with macroeconomic policy.

Conclusion

In extraordinary times the UK has an extraordinary opportunity. It can integrate climate change into its own economic recovery strategy and set out a financial plan to underpin its new NDC under the Paris Agreement, enabling finance to be channeled at scale to the new industries and infrastructure that are required for future UK prosperity. At the same time, the UK can use its international leadership roles in 2021 to leverage macroeconomic reforms through the financial system and build a willing coalition of countries which support the creation of a climate-safe global economic recovery. **This opportunity is unparalleled and is ripe to be seized.**

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[25] https://www.imf.org/en/News/Articles/2020/04/29/sp042920-md-opening-remarks-at-petersberg-event

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